R 4105-68 p (A)

The Conference Board

Economic and Business Environment Program

World Economic Monitor

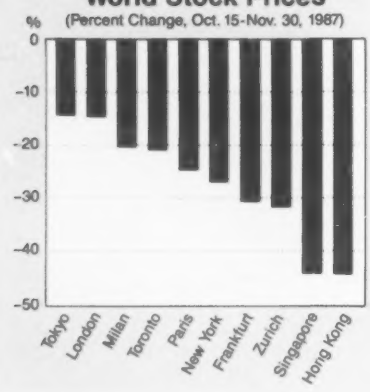
Volume 3, Number 1 Winter 1988

BACK TO THE DRAWING BOARD

The world that needs to be forecast has deteriorated. You used to be able to be pretty sure of getting things quantitatively right even if the magnitudes were wrong, but even that has disappeared.

Paul A. Samuelson in *The New York Times*, December 20, 1987.

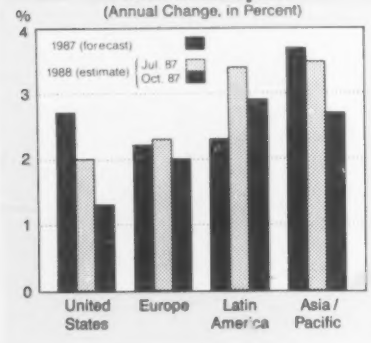
Chart 1
World Stock Prices
(Percent Change, Oct. 15-Nov. 30, 1987)



Members of The Conference Board's Economic Forum, meeting in mid-November, agreed that the October stock market collapse certainly spelled trouble for economic forecasting. Every component of the Forum's forecast for 1988 was colored by the drop in equity prices and thus had to be analyzed in terms of "before" and "after" the crash. Of course, the same holds true for the other major industrial countries.

Since sharply falling stock prices were not confined to the United States (Chart 1), the repercussions for the world economy are even more severe. For 1988, forecasters must not only estimate the crash's impact on consumption, investment, government spending and trade, but must also factor in such illusive variables as consumer confidence and investor psychology. Although these challenges make it more hazardous than usual to forecast worldwide economic activity—projections made early last fall are now of no value—it is possible to agree on some of the broader implications of last October's events. It is also worthwhile to frame some pertinent questions concerning the features of the economic landscape in the year ahead.

Chart 2
World Output
(Annual Change, in Percent)



The crash's implications for 1988:

- Slower economic growth in the major industrial countries will largely reflect the ripple effect of slower growth in the United States, rather than the "wealth effect" of the world financial market decline itself. This is in part because outside the United States equity holdings account for a far smaller share of private-sector financial assets.
- The worldwide inflationary threat has receded dramatically. Even before October 19, many observers felt that sharply rising commodity prices would soon moderate. The events of October, plus the outcome of OPEC's December meeting (pointing to lower oil prices), appear to support this view. For the industrial countries in particular, inflationary pressures will be related to the level of capacity utilization. On that basis, the risk of rising prices would seem greatest in the United States and least in Japan, with Europe somewhere in between.
- Although the major countries' monetary authorities have once more agreed to support the dollar, downward pressures on that currency may well persist until the United States convincingly addresses two fundamental economic imbalances—the trade and budget deficits. On that score, encouraging developments are likely to be seen sooner on the budget than on the trade front.

Copyright © 1988 by The Conference Board, Inc.

WORLD ECONOMIC MONITOR (ISSN 0896-2545) is published quarterly by The Conference Board, Inc., 845 Third Avenue, New York, N.Y. 10022. Printed in New York, N.Y. Application to mail at Second-Class Postage Rates is pending at New York, N.Y. POSTMASTER: Send address changes to The Conference Board, 845 Third Avenue, New York, N.Y. 10022.

The events of last October also raise some major questions:

- If the United States—which still accounts for almost one quarter of world output—grows even more slowly in 1988 than in 1987, who will take up the slack? Toward year-end, most of the major world players adopted economic measures that have been characterized as "therapeutic."

  The central banks of Germany, the United Kingdom, France, the Netherlands, Switzerland and Austria all lowered their discount or other key lending rates by 25 to 60 basis points, but these actions proved insufficient to support the dollar. In addition, Germany announced some modest fiscal measures, including interest subsidies on $13 billion worth of loans to small- and medium-sized businesses by an official lending agency, to be spread over the next three years. The German authorities took no action, however, to either reduce taxes or to boost government spending at this point.

  Japan did not join in the (obviously coordinated) European moves toward lower interest rates, presumably because of extraordinarily strong domestic growth. (The Japanese economy grew at an annual rate of over 8 percent in the third quarter.) Given a rise in business activity in Japan and postwar lows in German interest rates, these two countries may be able to take up some of the slack created by a slow-moving U.S. economy. However, they are not likely to concede any further expansionary measures.

- What is in store for privatization? Not only investors racked up losses as a result of October's crash. Given the uncertain investment climate, many governments also have had to reassess or postpone their plans for privatization—the selling off of publicly owned companies to the private sector. This has forced them to reduce their spending plans or to incur larger-than-planned budget deficits. The setback has affected most of Europe, from the major industrial countries to Spain and Turkey. For instance, Air France has delayed the planned sale of a 15 percent stake to the public, and the German government has postponed the long-awaited sale of its remaining 16 percent holding in Volkswagen until some time in 1988. In other words, the trend of recent years toward broadened stock ownership—what *The Economist* has called "the greatest exchange of money and property between private citizens and their governments"—has lost momentum.

- What is the outlook for further financial deregulation? It was widely assumed that the events of October would slow the pace of financial deregulation that had been under way in many countries. Many observers assumed that stricter supervision and controls would ensue. So far, even though there have been casualties among financial firms, there has been no major tightening in the regulatory environment. Progress on deregulation may be somewhat slower, however. The Swiss, for instance, are likely to tread carefully when they introduce a market in futures and options early in 1988.

- Has the much-touted coordination of international economic policy fallen victim to the market collapse? One might easily have thought so when efforts by U.S. officials to "talk the dollar down" were interpreted as a way of "punishing" the Germans for a rise in interest rates. (The temporary rise resulted from a proposed 10 percent withholding tax on interest payments that would take effect in 1989.) At the same time, the continued downward drift of the dollar between mid-October and Christmas raised doubts as to whether last February's Louvre Accord was still in force. The accord was designed to maintain some (unpublicized) target zones for the dollar. Although the seven major industrial countries announced on December 22 that they would continue to cooperate to keep the dollar from declining further, the statement did not hint at further policy changes on the part of any of the seven.

  Moreover, voices have been raised, notably that of former Council of Economic Advisers Chairman Martin Feldstein, to the effect that each government should learn to deal with its own problems and politicians should not attempt to escape their responsibilities by blaming poor domestic ecnomic performance on faulty policies abroad. According to Feldstein, writing in *The Wall Street Journal,* the United States should "end the international coordination of macroeconomic policy." While the United States might continue to exchange information about policy decisions with other major countries, "we should recognize explicitly that Japan and Germany have the right to pursue the . . . policies that they believe are in their own best interests." As Goethe once observed, if everyone swept in front of his own door, the whole world would be clean.

The Conference Board

845 Third Avenue, New York, N.Y. 10022 / 759-0900
1755 Massachusetts Avenue, N.W., Suite 312, Washington, D.C. 20036
255 Smyth Road, Ottawa, Ontario, K1H-8M7, Canada
Avenue Louise, 207-Bte 5; B-1050 Brussels, Belgium

Prepared by John Hein, Economic and Business Environment Program, Eric J. Kruger, Director. Reproduction permissible with full citation to The Conference Board as source. Published quarterly at 845 Third Avenue, New York, New York 10022.